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PREPARATION OF THE DRAFT FINAL REPORT

Draft final report of the Ad Hoc Working Group on Investment and Financial Flows

Amended text of Chapters I and II

I. INTRODUCTION

1. The Ad Hoc Working Group on Investment and Financial Flows held four sessions. At its first session in November 1992, it established its work programme (annex I) on the basis of the terms of reference adopted by the Trade and Development Board (decision 398 (XXXVIII). Subsequently, the Working Group held two sessions, in June-July 1993 and January 1994, to consider the following items of its work programme:

- Global trends and issues, including foreign investors' motivations;
- Host and home country policies and measures to promote foreign direct investment, including export processing zones and special economic zones;
- Multilateral measures to promote foreign direct investment;
- Portfolio equity investment and new mechanisms.

2. During these sessions, the Working Group also held two seminars. At these seminars, three topics were discussed, namely:

- Foreign investors' motivations;
- Foreign portfolio equity investment in developing countries and countries in transition;
- Private financing of infrastructure projects in developing countries, with special emphasis on build-operate-transfer (BOT) arrangements.

3. In addition to reports prepared by the UNCTAD secretariat, case studies were submitted by member countries on policies to promote foreign direct investment and portfolio equity investment, following a format proposed by the Chairman. Eleven countries prepared such studies, namely: Brazil, China, India, Mexico, Morocco, Myanmar, Netherlands, Nigeria, Philippines, Republic of Korea, and United States of America. The full list of the substantive documents submitted to the Working Group is given in annex II.

4 The Working Group also benefited from the participation of experts from member countries, representatives of international institutions, as well as non-governmental actors, especially from the private sector and the academic community. As of January 1994, 62 countries were members of the Working Group and 29 were observers (cf.annex III). Twenty-three member countries sent experts from their capitals to the second session and 22 to the third session.

5. This final report contains the Working Group's main findings and policy conclusions, as well as an assessment of the implementation of the Group's work programme, and identifies areas for further intergovernmental discussion and technical cooperation.

II. MAIN FINDINGS AND POLICY CONCLUSIONS

A. *Foreign direct investment*

1. Global trends and issues

(a) Traditional and new factors

6. The substantial increase in FDI flows to developing countries and countries in transition which had occurred recently had been the result of a large number of factors, including:

- A change of attitude in the host countries, which had welcomed FDI as a factor contributing to growth and efficiency;
- A change of attitude within companies themselves, which were working more closely with host countries on a partnership basis;
- An increase in global competition.

7. Several motives were involved in a firm's decision to invest abroad. These varied from firm to firm and sector to sector. They included the profit motive, safeguarding and gaining market shares, economies of scale, and a global competitive strategy.

8. Major factors influencing the location of FDI included the openness of the host economy, a fair and stable environment for FDI, domestic market potential, suitable export base, regional trading arrangements, availability of skilled labour, supportive infrastructure, and adequate domestic sourcing.

9. Among the traditional factors influencing FDI, it was felt that the low cost of unskilled labour was no longer a major determinant of FDI location.

(b) Globalization

10. Globalization had become a key feature of international economic relations, at the country level as well as at the firm level.

11. At the country level, almost all countries had opened their economies to the world or were in the process of doing so. This was particularly true of the former centrally-planned economies. At the firm level, globalization was an imperative for most firms, including small and medium-sized enterprises, under the pressure of global competition. Firms were increasingly applying global concepts to marketing, technology development, information systems, brands, market strategy and sourcing.

12. Globalization was reinforced by the close linkage between FDI and trade, notably through increased intra-firm trade and trade within regional groupings.

(c) FDI in the 1990s

13. The upward trend in FDI flows to developing countries and economies in transition was expected to continue in the 1990s, underpinned by competitive forces and further liberalization in these countries. However, constraints could emerge if economic uncertainty, coupled with low growth expectations, continued, especially in developed countries. The factors mentioned above would further increase competition among countries, including developed countries, in attracting foreign direct investment.

14. FDI should not be regarded as the only engine of growth in host countries. However, it could play a very useful role in the transfer of technology and the upgrading of skills in developing countries, thereby contributing to their overall development.

2. Home and host country policies

(a) General considerations

15. Governments of home and host countries had adopted various measures to encourage FDI in developing countries and countries in transition. Widely used instruments were bilateral investment protection agreements. These contained rules on fair and equitable treatment, free transfer of payments related to the investment, and international arbitration in case of disputes.

16. In addition, home countries had developed instruments to reduce perceived risks of FDI in developing countries and countries in transition. Mention was made of subsidies for feasibility studies, and of re-insurance of investments against political risks. With regard to the latter, experiences varied considerably among countries, depending on investment patterns and business culture.

17. Host country policies had an important bearing on the flow of FDI. Favourable policies ranged from general economic policies leading to a stable macroeconomic framework and liberalization of domestic financial markets to specific FDI-related measures such as transparent and non-discriminatory legal and regulatory systems, and free transfer of profits and capital repatriation.

18. Among the impediments to FDI as cited by investors were sectoral protection, ceilings on foreign ownership, licensing and approval procedures, performance requirements and restrictions on employment of foreign staff.

19. Most countries had embarked on wide-ranging economic reforms and on the liberalization of their economic policies in general, and of their policies towards FDI, in particular. The pace of liberalization varied considerably among countries, ranging from gradualism to shock treatment. For some countries, liberalization had helped to increase FDI flows; for others, especially many of the least developed countries, despite bold economic reforms, FDI did not flow as expected.

20. The trend towards regionalism was also noted. It was generally felt that the formation of regional trading groupings would have an important impact on the FDI pattern. In the foreseeable future, countries outside the regional groupings might be at a disadvantage in attracting FDI.

21. On the contribution of FDI to host countries' development and competitiveness, the Working Group noted that FDI played an important role in the industrialization process. However, some countries were concerned about the low level of large-scale FDI and FDI in high-technology sectors flowing to them.

(b) Economic policy framework

22. Since the 1980s, the trend towards liberalization and market-oriented reforms had characterized economic policies in most of the countries which had submitted case studies. The overriding theme was efficiency through competition. While most of the policy measures had been undertaken with broader macro-economic objectives in view, clearly these were positive elements which would be attractive to foreign investors. It was, however, hard to measure the precise and full extent to which these policies had influenced FDI flows to individual countries. Some of the reforms were too recent or were of a structural nature and would take time to be fully implemented, and it was, therefore, too early to assess their full impact on FDI.

23. The case studies revealed a high degree of policy convergence in terms of objectives but showed variations in approach, in timing and scope of reform, and in the effectiveness of specific measures in achieving desired results.

24. The broad objective of macroeconomic policies had been the achievement of sustained growth and stability, which were essential elements of an enabling investment climate. Fiscal reform had been aimed at keeping a lid on the budget deficit mainly through a more rational use of public funds on one hand and by broadening the tax base while at the same time reducing tax rates on the other hand. The main thrust of monetary policy had been to curb excess liquidity in order to attain price stability, while maintaining flexibility to stimulate growth. A gradual process leading to full currency convertibility had characterized exchange rate policies. There had also been a reduction in foreign exchange controls and a less interventionist approach to wage and price determination.

25. The case studies also showed that market-oriented reforms had affected a wide range of economic activities. The principal trade liberalization measures had involved significant reduction of tariff rates, simplification and rationalization of the tariff structure and a reduction or abolition of import-licensing requirements and quantitative restrictions. Industrial policy reform had been geared towards enhancing industry's contribution to development by emphasizing efficiency and competitiveness and a more outward orientation. The prominence given to the private sector was reflected in some countries in massive privatization programmes which had served as catalysts for FDI growth. A gradual opening of the financial sector to foreigners had been taking place. Measures to liberalize interest rates and create confidence in the financial system through strengthened regulatory framework and higher capitalization ratios had also been adopted.

26. In recognition of the importance of developing technological capabilities

not only to promote FDI but, above all, for the efficient functioning and modernization of the domestic economy, Governments had given priority to investment in infrastructure and human resource development. The growing awareness of the need for sustainable development had led to the establishment of regulatory frameworks for environmental protection.

27. The Working Group concluded that the macro-economic policy framework and policies and measures specific to FDI constituted only some of the elements, albeit vital ones, in investment location decisions. Host countries' economic potential and political stability and other factors that affected the risk and profitability of investment were equally important.

(c) Liberalization of FDI regimes

28. The 1980s had witnessed a marked change in the attitude of developing countries towards FDI, which was reflected in the widespread trend towards liberalization of FDI regimes. Variations existed, however, in the pace, timing and degree of liberalization. Specific measures to facilitate the entry of foreign investors included the shift to negative lists and simplification of administrative procedures. However, significant entry restrictions remained, especially in so-called sensitive areas such as natural resource exploitation, transport and communications, banking and financial services.

29. Governments had shown great willingness to act in areas where investors' concerns were more pronounced, such as those relating to the free transfer of profits and dividends, repatriation of capital, dispute settlement, protection of property rights, including intellectual property rights, and the removal or reduction of performance requirements. The principle of equal treatment was now generally recognized.

30. In recent years, the number of bilateral investment protection agreements and tax treaties had increased significantly. Membership in multilateral and regional investment guarantee arrangements was also increasingly seen as an important element in providing a stable and attractive framework as it could reduce perceived risks.

(d) Incentives and promotional measures to attract FDI

31. Fiscal, financial and other incentives remained an important part of host countries' investment promotion packages. Many countries had eliminated performance requirements, although others had maintained some to support development. Reliance on incentives was mostly used to promote priority sectors or to enhance the development of particular regions.

32. While the effects of incentives on stimulating new investments were difficult to measure, they nevertheless represented substantial costs for the host countries. Where incentives already existed, their sudden removal might produce negative effects; where they did not as yet exist, their introduction might not produce the desired results. To the extent possible, host countries

should seek to avoid competitive bidding, enhance exchanges of information and promote transparency in order to reduce unnecessary costs.

33. Much had been done to improve investment promotion activities with emphasis on information and advisory services, the establishment of one-stop shops for investment services, marketing and the use of joint investment fora. Debt-equity swaps in conjunction with privatization programmes had had salutary effects on new investment flows.

(e) Export processing zones (EPZs) and special economic zones

34. Several countries had established EPZs as a means of attracting FDI in export-oriented industries. EPZs were generally equipped with good infrastructure and support facilities and, in addition to customs privileges, operating firms were usually offered more generous incentives than those existing outside the zones.

35. Despite some failures, EPZs had largely met their objectives by attracting FDI, creating employment and increasing exports. Among the prerequisites for the success of an EPZ was a good location.

36. EPZs' effectiveness as an instrument for the achievement of long-term development objectives largely depended on the degree of linkages created with the domestic economy and on the extent to which they provided an avenue for the transfer of technology and of upgrading of skills. Backward and forward linkages had not in general developed to a significant degree, but in some cases, such as in the special economic zones, linkages had been strengthened.

37. Despite the growing trend toward trade liberalization, there was still a role for EPZs to play. EPZs could serve as windows for attracting FDI and for introducing market reforms gradually. They likewise had an important demonstration effect and could be used to promote new activities.

3. Multilateral measures to promote foreign direct investment

38. UNIDO, the World Bank and UNCTAD's Division for Transnational Corporations and Investment were engaged in the provision of technical assistance and advisory services with regard to the promotion of non-debt-creating flows, and FDI in particular. The experience with technical assistance received from these institutions had been found to be very valuable.

B. Foreign portfolio equity investment (FPEI)

1. Factors determining FPEI flows

39. The upsurge in the flows of FPEI to emerging markets (EMs) has been driven by factors specific to those markets, as well as by the global economic environment, particularly low interest rates. International investors, aiming to maximize returns and minimize risk, have found that EMs offer attractive risk-adjusted returns, as well as the opportunity to diversify portfolios.

40. Host country factors which have been crucial for investors' decisions to hold portfolios in an EM fall into three groups:

(a) The degree of political and macroeconomic stability and prospects for growth;

(b) The host country's commitment to the process of economic and financial liberalization and reform;

(c) The state of development of the host country stock exchange and the institutional and regulatory framework. The following variables were found to be important: size of the local stock market, number of listed companies, liquidity, number of participants, investor protection (such as insider trading regulations), enforcement of regulations, and volatility.

41. In addition, a number of other technical factors which might act as an obstacle to FPEI were identified. These are:

- Absence of a reliable and timely settlement system;
- Periodic closing of the stock exchange;
- Lack of information on quoted stocks;
- Absence of hedging instruments, in particular on currencies, the stock exchange index, and specific securities;
- Lack of a reliable and transparent accounting and auditing system.

42. Large discrepancies between various estimates of FPEI flows to EMs were

observed. This made it difficult to conduct a reliable analysis of FPEI flows. It was felt that this was mainly due to unsatisfactory data collection by host countries, which were invited to improve their data recording on foreign portfolio equity investment, especially foreign direct purchases in local stock markets.

2. Policy issues

(a) The role of stock markets

43. Stock markets and financial intermediaries, such as banks, are complementary in mobilizing resources for corporate financing. Stock markets help reduce the cost of raising risk capital, improve the allocation of resources within the economy and enhance firms' financial structure. Stock markets, and in particular second-tier markets, are an efficient source of finance for small and medium-sized companies, although their listing opportunities are limited in many EMs.

(b) Strengthening of local stock markets

44. The strengthening of local stock markets requires the development and broadening of the domestic investor base and the establishment of a healthy private sector. In this respect, three points were noted:

(a) Privatization has a role to play in broadening EMs and in increasing liquidity, particularly for countries in transition;

(b) A prudent regulatory framework will ensure investors' confidence in the stock market. The purpose of regulation should be to provide adequate investor protection, especially for minority shareholders. A balance should be found between self-regulation of the stock market and government regulation. Surveillance and regulation of the market should secure adequate disclosure and transparency;

(c) Stock market reforms to improve the transparency and efficiency of price dissemination are also recognized to be necessary. In parallel with these reforms, measures should be introduced to strengthen brokerage activities, such as those concerning minimum requirements of brokerage houses.

(c) Macroeconomic and financial impact of FPEI

45. FPEI, like any other form of capital inflow, could induce an appreciation of the real exchange rate and reduce the host country's control on monetary policy. However, in most countries, FPEI so far has had a negligible impact on these variables, as the amount of FPEI inflows in many cases represents only a small percentage of the money supply.

46. It was found that FPEI increased the efficiency of domestic stock markets through exposure to the international environment and reduced the cost of capital

for domestic companies. However, FPEI could increase the volatility of domestic markets.

47. It is difficult to set standards for the desirable speed and sequence of capital market liberalization across countries. However, there was a broad agreement on the merit of gradual opening of domestic stock markets to foreign investment.

3. Prospects for portfolio equity flows: the role of host and home countries

(a) Prospects

48. EMs will continue to provide good diversification opportunities for global portfolio holders and, most likely, above-average risk-adjusted returns. Over time, however, market forces in a globalized capital market will tend to move risk-adjusted returns closer together.

49. Owing to demographic factors and economic liberalization, private pension funds have grown substantially in a number of OECD countries. Together with other institutional investors, such as insurance companies and mutual funds, pension funds will continue to be an important source of capital for EMs.

50. Although recent trends in FPEI flows to EMs might have been partly driven by an international economic environment characterized by low world interest rates, a reversal of this situation is not likely to lead to large outflows of capital from EMs. It was noted that institutional investors have a long-term investment perspective, and that they tend to adjust their exposure gradually in times of bearish markets. There was nonetheless a case for examining further mechanisms designed to protect markets from excessive volatility.

51. Overall, it was agreed that the prospects for sustainable FPEI flows are good, especially in view of the growth potential of recipient countries and the continuing progress made in improving standards in EMs.

(b) Role of host countries

52. In order to sustain the international interest in EMs, Governments in host countries could take a number of steps including:

- Transparent economic policies and commitment to a longer-term package of regulatory and market reform;
- Taxation policies which are fair and non-discriminatory for foreign investors;
- Appropriate investor protection;
- Improvement of the settlement system;
- Encouraging frequent, periodic disclosure of financial information;
- Fostering the improvement of accounting and auditing practices;
- Considering the introduction of financial derivatives.

(c) Role of home countries

53. Home countries could facilitate the future development of EMs by taking the following steps:

(a) Allowing issues of securities in mature markets by emerging-market companies. Recent measures taken by the United States and Japan, which help improve the liquidity of privately-placed developing country securities, are a positive development.

(b) Relaxing regulations imposing ceilings on the share of foreign assets in the portfolios of institutional investors.

C. Build-operate-transfer (BOT) arrangements

54. In many developing countries and countries in transition, massive infrastructure investment requirements, coupled with government fiscal constraints, have led to a strong interest in BOT financing schemes. Among the main issues to be tackled are the need to restructure some utility sectors, the need for an improved regulatory environment, problems associated with demand risks and foreign exchange risks.

55. The enabling environment in the host country was judged to largely determine successful application of the BOT concept. The degree of development of the private sector and the legal and regulatory system was found to be particularly relevant in this context.

56. While BOT schemes have been applied in the transport, telecommunications, energy, water-treatment and waste-management sectors, other areas such as health and education could also lend themselves to the BOT technique.

57. Successful application of BOT techniques requires a thorough identification and evaluation of risks by both parties, i.e. the Government and the private sector. The contractual aspects of BOT projects are of great importance, as well as dispute settlement.